No. 15,247

In the United States Court of Appeals for the Ninth Circuit

LOUIS L. GOWANS AND HELEN T. GOWANS, HUSBAND AND WIFE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 53-67) are not officially reported.

JURISDICTION

This petition for review (R. 69-72) involves income taxes for the taxable years 1948, 1949, and 1950, in the total amount of $15,703.14 (R. 6, 70). On June 5, 1953, the Commissioner of Internal Revenue mailed to taxpayers a notice of deficiency in the amount of $9,561.30. (R. 28-29.) On September 4, 1953 (R. 3), taxpayers filed a petition (R. 5-27) with the Tax Court for a redetermination of that deficiency under the pro-

visions of Section 272 of the Internal Revenue Code of 1939. The decision of the Tax Court was entered on July 5, 1946. (R. 4, 68.) The case is brought to this Court by petition for review filed July 20, 1956. (R. 60-72). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court erred in holding the payments received by taxpayers in the years 1948, 1949, and 1950, for black sand removed from their land were taxable as ordinary income.

2. Whether taxpayers are entitled to refunds of amounts paid by them, as capital gain, on such income in those years.

STATUTES AND REGULATIONS INVOLVED

These may be found in Appendix A, *infra.*

STATEMENT

The facts, as stipulated and as found by the Tax Court (R. 53-65), may be summarized as follows:

At the beginning of the taxable year 1948 taxpayers owned two adjoining lots, Nos. 822 and 824, Makiki Round Top Lots, Honolulu. Lot 824, containing approximately three acres, was acquired in 1932. In 1937 taxpayers erected their home on it. Lot 822, containing approximately three acres, was purchased at public auction in 1938. The lots were situated on a hillside, and portions were so steep as to require extensive grading before they could be improved by buildings. By virtue of quarrying in the surrounding area taxpayers became aware that portions of their land contained black sand, a volcanic deposit or material used

in the construction of cinder and concrete building blocks. (R. 54.)

The Honolulu Construction and Draying Company, Limited, hereinafter referred to as Draying Company, is a Hawaiian corporation engaged in business as a general construction contractor and manufacturer of tile. In the fall of 1944 it offered to purchase from taxpayers that portion of lot 824 not essential to their homesite and the corresponding portion of lot 822, totalling approximately 4.4 acres, each lot being a source of black sand. It was discovered that taxpayers had not perfected title to lot 822 by erecting a residence thereon, as required by law, and also that under applicable law the lots could be used for residential purposes only and could not, without the consent of the Commissioner of Public Lands and the Governor, be conveyed to a corporation. Permission to convey the lower portion of lot 822 to Draying Company on condition that a house be constructed thereon, was requested in November, 1944, and refused. (R. 54-55.)

Thereafter taxpayers and Draying Company conceived a plan whereby the latter could obtain the black sand it needed for commercial purposes and taxpayers could fulfill their obligation to erect a residence on lot 822. Draying Company employed Rosewell Tewill, an engineer and surveyor, to determine the amount of black sand in the lower portions of both lots which it was economically feasible to remove, while having the area graded for use as a subdivision. His survey estimated that there were approximately 250,000 cubic yards of black sand beneath the surface of approximately 192,000 square feet of the sand area, which was the minimum amount that would have to be removed.

He further estimated that it would cost approximately $32,000 to grade the area conformably to the subdivision requirements after the removal of the overburden and the installation of a water pipeline and an access road. (R. 55-56.)

On September 4, 1945, taxpayers and Draying Company entered into the following written agreement (Stip. Ex. V):

> This Agreement, made this 4th day of September, 1945, by and between Louis L. Gowans and Helen T. Gowans, of Honolulu, City and County of Honolulu, Territory of Hawaii, hereinafter called the "Seller," and Honolulu Construction and Draying Company, Limited, a Hawaiian corporation, hereinafter called the "Buyer",
>
> Witnesseth: That
>
> Whereas the Seller is the owner of or has a certain interest in Lots 822 and 824 of the Makiki Round Top Lots; and
>
> Whereas a portion of said two lots comprises an area of approximately 192,000 square feet, hereinafter called the "Sand Area", as shown on a survey recently prepared by R. Towill; and
>
> Whereas, Buyer has estimated that the Sand Area has within it approximately 250,000 cubic yards of black sand which the Buyer wishes to acquire for business purposes; and
>
> Whereas, it is feasible and desirable to remove approximately 250,000 cubic yards of black sand from the Sand Area, and with proper grading thereafter to leave the Sand Area in a condition practicable and usable for home building sites, pro-

vided a 30-foot roadway can be obtained over and across certain intervening land owned by Fusao Hasegawa and Yoshiko H. Eguchi leading from the said area out to Round Top Drive; and

Whereas the Seller is presently negotiating with said Hasegawa and Eguchi for such a 30-foot roadway; and

Whereas the Buyer is ready and willing either to buy the interest of the Seller in the land comprising the Sand Area, or to quarry, buy and haul away black sand therefrom, and the Seller is ready and willing to sell same subject to prior consent thereto being given by the Commissioner of Public Lands, upon the terms and conditions hereinafter set forth;

Now Therefore, in consideration of the premises and the agreements hereinafter set forth on the part of the Seller and Buyer to be observed and performed, the Seller and Buyer agree as follows:

The Buyer hereby covenants and agrees to and with the Seller, his heirs and assigns:

1. To procure, at its own expense, a survey plan of subdivision of the Sand Area locating and showing thereon also a 30-foot roadway leading from the Sand Area over and across land owned by said Hasegawa and Eguchi to Round Top Drive;

2. With the consent of the Commissioner of Public Lands first obtained, to purchase all the right, title and interest of the Seller in and to the Sand Area, and to pay the Seller therefor the purchase price of Fifty Cents (50¢) per square foot of land within the Sand Area according to said survey;

3. If the consent of the Commissioner of Public

Lands to purchase the said interest of the Seller in and to the sand area cannot be obtained, but if permission to quarry and withdraw black sand from the Sand Area is obtained within a reasonable time after the date hereof, then the Buyer will quarry and haul away from Sand Area approximately 250,000 cubic yards of black sand and will pay Seller therefor at the rate of Forty Cents (40¢) per cubic yard for all black sand so withdrawn, on the following tems:

(a) To pay the Seller on or befoer the 15th day of each month for all black sand withdrawn during the month prior thereto;

(b) To keep accurate books of account and upon request to permit the Seller to examine the same;

(c) To save harmless the Seller from all loss, costs, damages, claims or suits of whatsoever nature resulting directly or indirectly from the operation of quarrying and removing black sand;

(d) Within five (5) years from the date hereof to quarry and remove approximately 250,000 cubic yards of black sand from the Sand Area;

4. After the completion of the removal of black sand as above provided, and before the expiration of five (5) years from the date hereof, to complete the grading of the proposed lots within the Sand Area subdivision, and to leave same in good order and condition for sale and use as building sites with road and water mains as shown by plans approved by the City Planning Commission,

5. Within five (5) years from the date hereof to grade and pave that portion of the 30-foot roadway, as shown on the subdivision map, which lies

within the land presently owned by said Hasegawa and Eguchi, in such manner as will satisfy the minimum requirements of the City Planning Commission, and in such manner as will make the same available for use to the owners of the lands comprising the premises owned by said Hasegawa and Eguchi;

6. Also within the said roadway, within said 5-year period, to install a water pipe line which will also be avalable for use to the owners of the Hasegawa and Eguchi premises and to be of such size and laid in such manner and connected with the Honolulu Water Supply System, as will satisfy the minimum requirements of the said City Planning Commission.

The Seller covenants to and with the Buyer, its successors and assigns, as follows: to sell and convey his interest in the land comprising the Sand Area, or approximately 250,000 cubic yards of black sand, upon the terms and conditions above set forth, and provided the consent thereto is first obtained from the Commissioner of Public Lands, and provided also that the necessary right of way is first obtained from said Hasegawa and Eguchi.

It is Mutually Agreed by and between the Seller and the Buyer as follows:

(1) With the consent of the Commissioner of Public Lands first obtained, the Seller's interest in the land shall forthwith be sold and conveyed to the Buyer and payment therefor made in preference to sale and withdrawal of black sand;

(2) That this agreement shall become effective and shall remain in force and effect upon obtaining

the appropriate approval and consent of the Commissioner of Public Lands, and not otherwise;

(3) In the event the Seller sells his interest in the Sand Area to the Buyer, property taxes shall be prorated as of the date of delivery of the deed;

(4) If the premises or any portion thereof are taken by condemnation proceedings and at the time title thereto remains in the Seller, then all compensation payable or to be paid for such taking shall belong to and be the sole property of the Seller, and the Buyer shall have no interest therein whatsoever, but this contract shall thereupon cease and determine with respect to the area or areas so taken.

In September, 1945, preliminary approval for the subdivision and the grading levels was obtained from the Planning Commission.

In order to aid taxpayers in perfecting their title to lot 822, Draying Company built a house thereon, begun in January, 1946, and completed in May, 1946, at a cost of $19,322.81. Draying Company was reimbursed through credits to taxpayers' account as royalties were earned, payment being completed in May, 1948. (R. 60.)

Since taxpayers did not perfect title to the lot until completion of the residence in May, 1946, Draying Company was delayed until July 1, 1946, in commencing performance under the agreement. In the removal of the black sand Draying Company was permitted to take quantities below the grade level where it was of usable quality and to fill the resulting holes with non-usable material. (R. 60.)

In 1947 taxpayers executed a note with the Bishop

National Bank of Hawaii, promising to pay $70,000 in monthly installments of $1,050 each. They assigned their rights in the agreement with Draying Company as security for the note. Draying Company was willing to make payments to the bank at such uniform rate since the parties had an oral understanding that production would be kept at an even pace over the five-year period. (R. 60-61.)

On May 19, 1950, taxpayers and Draying Company entered into an agreement (Stip. Ex. XII) extending the time for completion of the agreement to July 1, 1952, and providing that Draying Company would make monthly royalty payments of $2,040 to the Bishop National Bank until a note of taxpayers for $48,960 was paid off, and thereafter would make all further payments of royalty to taxpayers. It refers to the provisions of the earlier agreement and recites that the Buyer still has the right and obligation to remove approximately 133,000 cubic yards of black sand upon royalty payment of forty cents per cubic yard, and irrevocably assigns future royalty payments to the bank until the new note is paid. (R. 61-64.)

In order to meet the deadline of July 1, 1952, Draying Company rented extra land and stockpiled approximately 100,000 cubic yards of black sand. It finished its operation in 1952. (R. 64-65.)

Sand removed and payments made were as follows:

Years	Cubic Yards	Cash Payments
1947	35,897.47	$ 14,358.98
1948	30,694.50	15,463.83
1949	40,356.25	12,600.00
1950	44,692.25	19,126.57
1951	16,414.50	24,480.00
1952	81,955.03	13,974.62
Total	250,010.00	$100,004.00

The above payments were charged on the books and records of Draying Company to royalty accounts either as prepaid or accrued, dependent upon the amount of black sand actually removed during the period of payment. In its correspondence with taxpayers concerning payments Draying Company regularly referred to the payments as royalties. (R. 65.)

On their income tax returns for 1948 to 1950, inclusive, taxpayers reported the respective amounts of $14,653.60, $12,600, and $17,086.57 as long-term capital gain from the sale of a capital asset taxable at the rate of 50 per centum. In determining his deficiency the Commissioner increased the amounts reported and held that the full amounts were taxable as ordinary income. (R. 65.)

For each of the taxable years 1948, 1949, and 1950, taxpayers did not claim and the Commissioner did not allow any amount for depletion of the black sand. (R. 65.)

The court below held that during each of the taxable years 1948, 1949, and 1950, taxpayers retained an economic interest in the black sand in place contained on their lots, and that the amounts received under the contract are taxable as ordinary income. (R. 66.) The court held that the decision in the case of *Crowell Land & Mineral Corp.* v. *Commissioner,* 25 T. C. 223, appeal argued, January 28, 1957 (C. A. 5th) (Appendix B, *infra*), is controlling here. (R. 66.)

Taxpayers presented an additional contention, that the agreement of September 4, 1945, having been a sale, and no initial payment having been made, they should have reported the gain as income of the year of the sale. They were not entitled to report the payments received

in 1948, 1949, and 1950, on the installment basis, they assert, and accordingly are entitled to a refund for those years. Since the Tax Court held that the payments were taxable as ordinary income it did not reach this contention.

SUMMARY OF ARGUMENT

I

Taxpayers entered into a contract with Draying Company whereby the latter was to remove approximately 250,000 cubic yards of black sand from taxpayers' land, paying 40 cents per cubic yard. Under the principles applicable to the extraction of natural resources the payments received by taxpayers from the extraction of the sand were taxable as ordinary income if under the agreement taxpayers retained an economic interest in the sand in place, prior to its removal.

Taxpayers did retain such an economic interest, their income being dependent upon extraction and measured by it. They retained the fee interest in the land, paid the taxes on the entire property, reserved the right to the entire compensation paid if the premises were taken by condemnation, and necessarily had a reversion of all the sand not extracted within the time limits set by the agreement. The agreement did not have the characteristics of an outright sale, there being no precise agreement as to the specific property included, no deed conveying title, no fixed purchase price payable in all events. The agreement, and the conduct of the parties under it, bring the transaction within those where the payments are held to be ordinary income, subject to a depletion allowance, rather than capital gain.

II

Taxpayers' alternative contention, that they are liable for no taxes at all upon the payments received in the taxable years, was not reached by the Tax Court. If this Court should disagree with the Tax Court on the first point, a remand would be necessary for fact findings essential for a determination as to whether taxpayers improperly reported the gain on the installment basis, and if it be held that they did, whether they are nevertheless taxable on the payments in question.

ARGUMENT

I

The Payments Received by Taxpayers for the Sand in the Taxable Years Were Taxable as Ordinary Income Since Taxpayers Were the Possessors of an Economic Interest in the Sand

Whether the payments received by taxpayers in 1948, 1949, and 1950, were taxable as ordinary income turns on the question whether under the agreement with Draying Company they retained an economic interest in the black sand in place on their lots.

The concept of economic interest arises from "the peculiar character of the business of extracting natural resources." *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 33. Their mining is treated as an income-producing operation, not as a conversion of capital investment as upon a sale. But minerals and natural deposits are recognized as wasting assets, and as compensation for the capital asset consumed in the production of income through severance the owner is entitled to a deduction from gross income for depletion, which is

regarded as a tax-free return of the capital consumed. *Anderson* v. *Helvering,* 310 U.S. 404, 407-408.

If the owner has completely disposed of his interest in the mineral, however, there is a sale of that interest, subject for tax purposes to capital gains treatment. In deciding the nature of the transaction, the nature of the income and the right to a depletion allowance have always been considered as related questions. He who has an economic interest in the mineral receives ordinary income and is entitled to a deduction for depletion. On the other hand, upon an outright sale, the seller who retains no economic interest is not entitled to a depletion allowance on the payments. The payments received in the transaction are either ordinary income or capital gain or loss, the taxpayer having no right of election as to which is more favorable to him. Although the taxpayers here do not seek depletion allowances,[1] another taxpayer in similar circumstances would be entitled to that allowance and might by the present taxpayers' argument be precluded from obtaining it. In *Palmer* v. *Bender,* 287 U. S. 551, 557, the test for determining whether a taxpayer retained an economic interest, and accordingly whether the income received was ordinary income, was set out in broad terms:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

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[1] Prior to 1951 only ordinary cost depletion was available for sand and gravel. By Section 319(a) of the Revenue Act of 1951, c. 521, 65 Stat. 452, sand and gravel were added to the list of products qualifying for percentage depletion.

Again in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25, 32, the Court explained that—

> It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion.

and that (pp. 34-35)—

> Depletion depends only upon production. It is the lessor's lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil.

Most recently in *Commissioner* v. *Southwest Expl. Co.,* 350 U. S. 308, 314, the Court quoted from *Palmer* v. *Bender, supra,* and stated that the two factors of (1) having acquired, by investment, an interest in the oil in place and of (2) securing income derived from the extraction of the oil, to which he must look for a return of his capital constitute the requirement of "an economic interest."

See also the recent opinion of this Court in *Usibelli* v. *Commissioner,* 229 F. 2d 539, where the basic considerations involved in determining the presence of an economic interest in a mineral in place are reviewed.

Judged by these tests, taxpayers here had an economic interest in the sand. There is no question as to the first factor, that they acquired their interest in the sand by investment. It is equally clear that their income was secured by extraction of the sand, to which they looked for a return of their capital.

Article 3 of the contract (Ex. V) provides that Draying Company will "quarry and haul away" approxi-

mately 250,000 yards of sand, and will pay "at the rate of" 40 cents per cubic yard for all black sand "so withdrawn." Payment is to be made each month as the sand is withdrawn. This provision is precisely within the tests set out. If the question were the related one of taxpayers' right to depletion, the deduction for depletion would be allowed since the income was based upon the extraction of the sand, but only as and to the extent that sand was removed.

If, however, we are to look beyond the precise language of the Supreme Court, it becomes even more apparent that the taxpayers retained an economic interest in the sand in place. They point out (Br. 12) that in the *Crowell* case there was a specific provision for reverter of the unremoved sand at the end of five years, where here there was no reverter clause. But as the Tax Court pointed out in the *Crowell* case (Appendix B, *infra*), in the usual mineral lease, at the end of the lease period the unremoved mineral automatically reverts to the fee owner, without a reverter clause, citing *Burnet* v. *Harmel*, 287 U. S. 103. Here the contract had a specific five-year limitation, so significant that Draying Company was willing to bargain for a one-year extension. The effect of that period of limitation is clearly that at the end of the agreed upon time Draying Company would have no further right to the sand.

Under the agreement, therefore, Draying Company acquired title to the sand only as it was removed, and was obligated to pay for it only as it was removed. Taxpayers retained ownership until the act of removal, with complete ownership remaining in any sand not removed during the five-year or extended period during which Draying Company had the right to extract and remove sand.

Taxpayers, while arguing that Draying Company had an obligation to remove the sand (Br. 13), do not suggest that its rights in unremoved sand continued beyond the five-year period, nor do they suggest what would happen to the unremoved sand other than to revert to them. Under these circumstances the obligation to remove sand is no more than the customary obligation to exploit a mineral lease.

Furthermore, the agreement itself shows that taxpayers retained an interest in the sand until it was removed. Paragraph (4) provides that if the premises or any portion are taken by condemnation proceedings, and at the time title remains in taxpayers (an obvious reference to the alternative attempted sale of the fee to Draying Company), then all compensation for such taking shall belong to and be the sole property of taxpayers, Draying Company shall have no interest therein whatsoever, and the contract shall cease and determine with respect to the area taken. This is completely inconsistent with the claimed sale of a body of sand in place. If the agreement were such a sale, Draying Company would be entitled to just compensation for its sand. On the contrary, the provision contemplates taxpayers as being the ones entitled to compensation for the sand as well as other property taken.

Of course, as the Court decided in *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, and in *Anderson* v. *Helvering*, 310 U. S. 404, the owner of minerals may make an outright sale and divest himself of all economic interest therein. Taxpayers assert that that is what they did here. But in the former case the taxpayer had never owned any of the land in fee; in the latter case the Court emphasized the fact that the seller conveyed not

only its royalty interests and oil and gas rights but also its fee interests. In the present case, on the contrary, taxpayers did not convey the fee, but only rights to the sand deposits. See *Commissioner* v. *Crawford,* 148 F. 2d 776 (C. A. 9th).

Taxpayers argue (Br. 244) that the transaction was an outright "sale of a slice out of the side of the mountain" down to predetermined grade levels, rather than a disposition of sand. But the entire transaction is inconsistent with such a sale. The parties, in actually carrying out the contract, disregarded those grade levels in so far as extraction of the sand was concerned. Draying Company went below the pre-determined levels to take out from 80,000 to 100,000 yards of sand, leaving a hole, about 40 feet wide, 150 feet long, and 70 feet deep, which it filled up with hard rock. (R. 101-102.) Also, there was no instrument conveying any specifically described piece of property. There was no provision during those years for Draying Company to pay taxes on the property which it is now asserted belonged to that company. On the contrary taxpayer paid the taxes himself for all the years from 1946 through 1952. (R. 143-144.) The contract contained no provision for any lump sum payments. Although the expense of constructing a house on Lot 822 in order that taxpayers might get clear title was borne by Draying Company and may be considered as initial payments, it was treated as advance royalties, to be worked off in terms of cubic yards of sand removed, rather than as a portion of a total purchase price. (Ex. VII.)

Taxpayers argue that the fact that the agreement is phrased in terms of a seller and buyer is of particular significance (Br. 12, 19) while arguing that the fact

that Draying Company consistently referred to the payments as "royalties" is to be disregarded (Br. 23). It is settled, however, that the terminology used does not determine the question, either way. *Palmer* v. *Bender,* 287 U. S. 551, 555-556; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25, 32; *West* v. *Commissioner,* 150 F. 2d 723, 726 (C. A. 5th). It is the acts of the parties and the actual effect of their promises which determine the tax consequences. *Hamme* v. *Commissioner,* 209 F. 2d 29, 31, 32 (C. A. 4th).

Again, taxpayers attach significance to the fact that payments were made by Draying Company in advance of sand actually removed. (Br. 11-12.) But advance or minimum payments are consistent with a lease. *Kittle* v. *Commissioner,* 21 T. C. 79, affirmed, 229 F. 2d 313 (C. A. 9th). In fact, however, there were occasions when the payments ran behind the removal of sand, but Draying Company's books showed a credit to taxpayers. (R. 149). The regularity of payments, then, is not evidence that the transaction was a sale. Payment was still agreed to be out of production.

Taxpayers alternatively argue that even if the 1945 agreement was not a sale, its amendment in 1950 converted it into a sale. (Br. 24-27.) The amendment, however (Ex. XII), besides extending the time for Draying Company to remove the sand, merely increased the periodic payments and provided for Draying Company to make them to the bank on behalf of taxpayers, until their note should be paid off. Thereafter payments were to be made directly to taxpayers again. In so far as Draying Company was concerned, its obligations under the agreement remained essentially the same as before. In so far as taxpayers were concerned they continued to be paid on the basis of

production, retaining the same economic interest as before.

To summarize, the contract here had the characteristics of the usual mineral lease: payment was to be made only as the sand was removed and at a rate fixed by the removal; there was an obligation to exploit derived from the time limit, with all rights to revert to the owner of the fee at the expiration of that time limit; the fee was retained by taxpayers; in the event of condemnation the owners wre to receive in full all payments and Draying Company's right to remove should terminate; the owners continued to pay all taxes on the entire property. Conversely, the characteristics of an outright sale were lacking; there was no lump sum payment either made or agreed upon; Draying Company was not obligated to pay in all events any fixed total amount of any fixed installments; there was no deed of conveyance; there was no fixed description of the property, Draying Company being permitted to take nearly 100,000 of the 250,000 yards from below the grade level and to reject an equal amount of material from above the grade level. In these circumstances taxpayers retained far more than has been required to meet the test of an economic interest, and can in no way be said to have disposed of their entire interest in the sand.

Taxpayers' Alternative Contention That for the Taxable Years (1948, 1949, and 1950) They Were Liable for No Taxes on Account of Income Received From the Sand, Even as Capital Gains, Is Without Record Foundation, Is Incorrect and, in any Event, Would Require Remand in the Tax Court for Decision

In their last point (Br. 27-28) and in two cursory paragraphs taxpayers claim they are not liable for any taxes whatsoever for the taxable years (1948, 1949, and

1950)—not even as capital gains—on income derived from the black sand. Indeed, they request refund of the taxes already paid by them for those years on the capital gains basis.

The Tax Court, having decided the issue discussed in Point I, *supra,* in the Commissioner's favor, never reached this contention and did not pass on it. Likewise if this Court agrees with the Tax Court on Point I, namely, that the payments received for the sand during the taxable years were ordinary income, it is unnecessary for this Court to afford consideration to this Point II.

However, if this Court disagrees with the Tax Court on Point I, remand in the Tax Court would become necessary for fact findings essential for determination as to whether or not taxpayers improperly, as they now contend, reported their capital gain on the transaction on an installment basis. Thus, it will become necessary to determine what was the year of the sale for this purpose (1945, or 1946 when taxpayers obtained title to lot 822). It will also become necessary to find when the initial payment was made. In stating that there were no payments on account of sand until 1947, taxpayers ignore the fact that in 1946 Draying Company paid $19,322.81 to build a house for them on lot 822 (R. 60, 158), for which the company was to be reimbursed through credits as royalties were earned (Ex. VII). Such advance payments may be held to qualify as initial payments. Taxpayers, therefore, properly reported the income on the installment basis.

Again, taxpayers' argument that they should have returned the whole amount of the alleged capital gain on the contract in 1945 or 1946, is based on the premise

that their fair market value of the unexecuted contract was ascertainable in those years (see Section 111(b), Internal Revenue Code of 1939). But this record clearly does not establish that its value was ascertainable in those years and, if so, in what amount.

Again, when the facts are found, the impact of Section 3801 of the 1939 Code must be considered.

CONCLUSION

The decision of the court below is correct and should be affirmed. If this Court should disagree the case should be remanded for further findings relative to Point II.

Respectfully submitted,

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February, 1957.

APPENDIX A

Internal Revenue Code of 1939:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Sec. 44. Installment Basis.

* * * * *

(b) *Sales of Realty and Casual Sales of Personality.*—In the case of (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under

regulations prescribed by the Commissioner with the approval of the Secretary be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U.S.C. 1952 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money).

* * * * *

(26 U.S.C. 1952 ed., Sec. 111.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.44-2. *Sale of Real Property Involving Deferred Payments.*—Under section 44 deferred-payment sales of real property include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling

price has been paid, and (b) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments. Such sales, either under (a) or (b), fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 30 percent of the selling price.

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44, in sections 29.44-1 and 29.44-3, and in this section. The term "initial payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the

amount of the "initial payments," the "total contract price," or the "selling price." The term "initial payments" contemplates at least one other payment in addition to the initial payment. If the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.

SEC. 29.44-3. *Sale of Real Property on Installment Plan.*—In transactions included in class (1) in section 29.44-2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

*   *   *   *   *

SEC. 29.44-4. *Deferred-Payment Sale of Real Property Not on Installment Plan.*—In transactions included in class (2) in section 29.44-2, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

*   *   *   *   *

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be tax-

able to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

APPENDIX B

OPINION

The Tax Court of the United States

Filed October 31, 1955

Docket No. 53476

CROWELL LAND & MINERAL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Amounts received by petitioner pursuant to an agreement transferring rights to remove sand and gravel over a 5-year period and fixing the payments by reference to a price per unit, subject to advance payments, held taxable as ordinary income and held, further, not subject to an allowance for discovery depletion.

Richard L. Crowell, Esq., for the petitioner.

Robert B. Wallace, Esq., for the respondent.

Opper, Judge: Respondent determined a deficiency of $1,839.12 in petitioner's income tax for 1949. The issues for decision are whether payments, received by petitioner during 1949 under a "Contract of Sale" of gravel, represent long-term capital gain, as reported by petitioner, or ordinary income, as determined by respondent, and if they represent ordinary income,

whether petitioner is entitled to an allowance for discovery depletion. The parties have filed a stipulation of facts, all of which are hereby found accordingly.

Petitioner is a corporation whose income tax return for 1949 was filed with the collector of internal revenue for the district of Louisiana.

Petitioner entered into a "Contract of Sale" dated January 8, 1947, with Gifford-Hill and Company, Inc., a corporation. The contract, which named petitioner the vendor and Gifford-Hill the vendee, provided that the vendor sold to the vendee, with full warranty of title, "All gravel, sand, mixed sand and gravel, railroad ballast and other similar construction materials situated on and under" the piece of land described in the instrument, consisting of about 23.21 acres. Prior to the consummation of the contract there was found to be a substantial deposit of sand and gravel on this land. Tests were made but it was impossible to determine the exact quantity of sand and gravel thereon.

Under the agreement, "The consideration for this sale and transfer is the payment by the Vendee unto the Vendor, the sum of Fifteen (15¢) cents per cubic yard" for "each and every cubic yard thus mined and removed" payable $1,200 upon the execution of the instrument and $1,200 "at the beginning of each year, thereafter during the term of this Contract of Sale" as advance payments, and 15 cents per cubic yard additional when the amount removed equaled the cumulative advance payments. The agreement provided that upon default the contract would be canceled and the vendee would reconvey all of the remaining property to petitioner. The vendee was given 5 years within which to go upon the property and remove the subject material after which its rights terminated and the property was to revert to the vendor, the vendee to execute a reconveyance of the remaining property. The vendee

was given the right to construct, maintain and take away necessary camps, tracks and other improvements. Any timber cut in the course of removing the materials was to be delivered to and remain the property of the vendor and any damaged timber was to be paid for by the vendee at stated prices. The vendor was to pay advalorem taxes on the land and the vendee was to pay severance or other taxes imposed for materials removed by it under the agreement. The vendee was to hold the vendor harmless from all damage to persons or property resulting from its operations. Vendor and vendee agreed that any mineral operations of the vendor and the operations of the vendee would be carried on so that neither would interfere with the other.

Petitioner, in 1949, was the fee owner of more than 100,000 acres of land in Louisiana which had been acquired in 1941, and this is the only instance in its history of a contract of any nature concerning sand and gravel deposits underlying any of its land. The sand and gravel deposit in controversy was not carried or listed in the inventory of petitioner.

The purchaser removed the sand and gravel under the contract and thereafter, as a result, the 23.21-acre tract was mostly covered with water.

Petitioner received $14,147.04 under the contract during 1949 and reported the amount as a long-term capital gain. Respondent determined that the amount represented ordinary income.

While the concept of taxable gain implies that a taxpayer shall be authorized to recover his capital in some manner, a number of methods to accomplish this are available. That provision is made for a return of capital as an offset against taxable income is accordingly of little assistance in determining whether a specific transaction gives rise to ordinary income or capital gain. If

capital gain, the investment is to be recovered by means of an allocated basis. Section 111(a), Internal Revenue Code of 1939. If ordinary income, an elaborate system has been established by means of depreciation, depletion and other processes to achieve a similar result. And percentage depletion, section 114(b)(3) and (4), Internal Revenue Code of 1939, discovery depletion, section 114(b)(2), Internal Revenue Code of 1939, and unit depletion are all various means of accounting for depletion. Unit depletion, for example, may be available when discovery depletion is not. Cf. *Parker Gravel Co.*, 21 B.T.A. 51, with *Robert Roberts,* 20 B.T.A. 345.

It is clear, however, that if depletion of any kind is available it must be because the taxpayer has retained an economic interest in the mineral in place. *Anderson* v. *Helvering,* 310 U.S. 404; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25. The principle is that as the mineral is removed, and not before, the taxpayer is being deprived of a part of his property and simultaneously using up a corresponding portion of his basis. Presumably since the process of removal is not subject to prophetic anticipation the income is to be accounted for from time to time as it is actually earned. Thus, the present agreement, although it purports to pass present title to all minerals involved, calls for payment, except for the guaranteed amounts, only as the sand and gravel is "mined and removed from said premises."

Not only the time of removal, but the act itself is shrouded in the mists of speculation. At the end of the lease period, even if none is removed, the mineral remaining is not the property of the lessee, but of the lessor. In the usual mineral lease, this results automatically, see, e.g., *Burnet* v. *Harmel,* 287 U.S. 103, while here there is an express provision to that effect. The difference cannot be decisive. Payment for de-

posits only as removed and retention (or retransfer) of title to the balance are typical indicia of the existence of an economic interest.

It is idle to suggest that these transactions do not somewhat resemble sales, just as a lease of real property has aspects of the day-by-day conveyance of the property to the tenant. As each cubic yard of sand or each ton of coal or metal ore is removed and the owner is paid for that much of the mineral, the transfer is indeed in many ways comparable to the sale of a capital asset. This is so whether the arrangement calls for so much a yard or a ton, *Bankers' Pocahontas Coal Co.* v. *Burnet,* 287 U.S. 308, *Otis A. Kittle,* 21 T.C. 79, or a varying amount depending upon retail price, *William Louis Albritton,* 24 T.C. 903, net profit, *Burton-Sutton Oil Co.* v. *Commissioner, supra,* or the like. The continuous deterioration of other property compensated for by depreciation has also been likened to a series of fractional sales. *United States* v. *Ludey,* 274 U.S. 295. That detail of income tax accounting has not sufficed to transform an item accountable for as ordinary income into capital gain.

The recovery of capital by depletion in the case of minerals is comparable to the process of deducting for depreciation. *United States* v. *Ludey, supra; Choate* v. *Commissioner,* 324 U. S. 1. And by the same token when, under a mineral lease, the property is removed bit by bit and the consideration for it is paid over a number of years, the impelling reason for conferring upon a taxpayer the benefit of capital gains treatment tends to disappear. He does not receive in one year, subject to high surtax rates, the proceeds of an asset which may atually represent the cumulation of increments in value over a long period. See H. Rept. No. 350, 67th Cong., 1st Sess. (1921), p. 10; S. Rept. No. 275, 67th Cong., 1st Sess. (1921), p. 12. On the con-

trary, provisions in the present agreement expressly granting rights to the use of the surface ~~surtax~~ are spread over the entire 5-year term and are presumably being paid for from year to year. *Burnet* v. *Harmel, supra.*

In the case of the kind of agreement with which we are here confronted, it is of little consequence whether it is described as a lease, royalty agreement, bonus, advance royalty or other arrangement for periodic payment. *Arthur S. Barker,* 24 T.C. 1160. The typical treatment has been to regard the proceeds as ordinary income. *Burnet* v. *Harmel, supra; Hamme* v. *Commissioner,* (C.A. 4) 209 F. 2d 29, certiorari denied, 347 U.S. 954. Both as a consequence and as a compensation the taxpayer has been accorded the privilege of offsetting the receipts by depletion allowances. *Palmer* v. *Bender,* 287 U. S. 551.

As we said in *William Louis Albritton, supra:*

> But the nature of the income and the taxpayer's right to a depletion allowance have always been considered as related questions. * * * Another taxpayer under similar circumstances but seeking to obtain the benefit of depletion might make this petitioner's argument in reverse. If we were to sustain petitioners here, that taxpayer would have to be frustrated.

This is reinforced in the case of sand and gravel by the provisions of the Internal Revenue Code of 1939, section 114(b)(4)(A)(i), as amended by section 319(a), Revenue Act of 1951, extending to the owners of sand and gravel deposits the benefits of percentage depletion. See also, e.g., *United States* v. *Cherokee Brick & Tile Company,* (C.A. 5) 218 F. 2d 424. If these receipts are to be considered as capital gain recoverable by an allocation of the taxpayer's basis rather than as ordinary income with a corresponding deduction for depletion, it seems to us to lie within the province of

Congress to create that variation in approach.[1] On the basis of the authorities as they now exist we are unable to sustain petitioner's contention.

Petitioner's alternative claim is that it is entitled to "discovery depletion." No factual foundation for such a deduction appears in the record, and with the case in its present posture, discovery depletion—as opposed to depletion generally—was not available to this petitioner. *Parker Gravel Co., supra.*

Reviewed by the Court.

Decision will be entered for the respondent.

Murdock, J., dissenting: The petitioner was not engaged in the business of selling sand or gravel or in the business of selling sand and gravel deposits. Counsel for the respondent refers to this contract of sale as a lease, regards it as similar to an oil and gas lease, and claims that the payments received were royalty payments under a lease rather than amounts realized from the sale of a capital asset. His basis for calling the instrument a lease instead of a contract of sale, as it purported to be, is based primarily upon the method of payment and the limitation of five years allowed for the removal of the material.

The cases cited by the Commissioner are all part of a line of decisions of which *Burnet* v. *Harmel,* 287 U.S. 103 and *Palmer* v. *Bender,* 287 U.S. 551 are early examples. The rules established by that line of cases are that any one who was entitled to receive a portion of the mineral extracted or produced from a property, a

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[1] Congress has evidenced its views to that effect with respect to coal, section 325, Revenue Act of 1951, and timber, section 127, Revenue Act of 1943. But that legislation extends only to coal and timber and does not include such other natural deposits as metal ores, *Otis A. Kittle,* 21 T.C. 79, oil and gas or sand and gravel, *William Louis Albritton,* 24 T.C. . . . (August 16, 1955).

portion of the income from the operation of the mineral property or an amount based upon the income or the value of the mineral produced from the property, had an "economic interest" in the mineral in place and as that interest was depleted by the production operation the person was entitled to recovery through depletion, particularly percentage[2] depletion based upon the gross income from the property, and the amount he received for his retained share of production or as his share of the profit from or value of the production was taxable as ordinary income rather than gain from the sale of a capital asset.[3] The *Harmel* and *Palmer* cases involved oil and gas leases and most of the cases following them also involved mineral leases under which the taxpayers became parties to the extracting operations so that a part of the gross income from the properties was their income.

The present case presents a different situation. The petitioner sold the material here in question for a fixed price, 15 cents per cubic yard removed. Nothing was to vary that price or the vendee's obligation to pay it. The entire purchase price would be paid in less than five years if the material was all removed sooner. The five years was not a rental period. The petitioner was not entitled to receive or to be credited with any part of the material as removed. It was not to share in any profit or income derived by the vendee from the removal

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[2] The natural deposit here involved was not subject to percentage depletion in 1949, the petitioner claims no depreciation under this sale contention, and both parties recognize that no mining is involved herein. See section 114(b)(4); *Parker Gravel Co.*, 21 B.T.A. 51.

[3] However, *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S. 372, held that there was a sale of a capital asset even though the seller was to share in the net profits of production.

of the material. The amount the petitioner was to receive did not depend in any way upon the vendee's income from the removal of the sand and gravel or upon the unit or other value of the material removed. The total amount received by the vendee from the sale by it of material removed belonged to it and no part thereof belonged to the petitioner. Cf. *Thomas* v. *Perkins,* 301 U.S. 655; *Anderson* v. *Helvering,* 310 U.S. 404. The contract of sale here was substantially different from the mineral leases involved in the cases cited by the petitioner and the facts that the method of payment here was based of necessity upon the amount of material removed, a time limit for removal was set and the vendee was permitted to come upon the property to remove the purchased material are not sufficient to twist this contract of sale into a lease similar to the mineral leases in the cases cited by the Commissioner.

The petitioner argues that the contract was in all respects a contract of sale rather than a lease, the five years was regarded as ample time by the parties to permit the removal of all of the material and the method of payment was made necessary by their inability to determine in advance just how much material was there. The Commissioner does not advance any sound reason for regarding this instrument as a lease instead of a contract of sale, and he cites no authority which really supports his argument. The stipulation shows that the gravel deposit was a capital asset of the petitioner which it had held for more than six months prior to sale, and the gain should be treated for income tax purposes as a long-term capital gain. This is a stronger case for capital gain treatment than cases involving sales of standing timber where payment was from profits. See *John W. Blodgett,* 13 B.T.A. 1388; *J. J. Carroll,* 27 B.T.A. 65 affd 70 F. 2d 806; *Estate of M. M.*

Stark, 45 B.T.A. 882; *Camp Manufacturing Co.*, 3 T.C. 467; *Isaac S. Peebles*, Jr., 5 T.C. 14; *Warner Mountains Lumber Co.*, 9 T.C. 1171; *United States* v. *Robinson*, 129 F. 2d 297.

Johnson and Fisher, J. J., agree with this dissent.
(Seal)

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